



Signed and Filed: September 4, 2012

A handwritten signature in dark ink, appearing to read "T. E. Carlson".

THOMAS E. CARLSON
U.S. Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF CALIFORNIA

| | | |
|-------------------------|---|---------------------------|
| In re |) | Case No. 11-33306 TEC |
| |) | |
| MAUREEN BARBARA KENNEY, |) | Chapter 7 |
| |) | |
| Debtor. |) | |
| |) | |
| FRANK BROWN, |) | Adv. Proc. No. 11-3227 TC |
| |) | |
| Plaintiff, |) | |
| |) | |
| vs. |) | |
| |) | |
| MAUREEN BARBARA KENNEY, |) | |
| |) | |
| Defendant. |) | |
| |) | |

MEMORANDUM DECISION

This is an action in which Plaintiff seeks to except from Debtor's discharge the liability established in a court-confirmed arbitration award. On July 27, 2012, the court held a hearing on a motion in which Plaintiff seeks summary judgment on his non-dischargeability claim and seeks to dismiss Debtor's breach-of-contract counterclaim. David J. Cook appeared for Plaintiff Frank Brown. Michael S. Keck appeared for Debtor/Defendant Maureen Kenney. Upon due consideration, and for the reasons stated below,

1 I determine that Plaintiff's motion for summary judgment should be
2 granted and that Defendant's counterclaim should be dismissed.

3 **FACTS**

4 This dispute grows out of a partnership agreement between
5 Brown and Kenney. In June 2006, Brown purchased real property at
6 1094-1096 Union Street/2008, 2022-2024 Leavenworth Street, San
7 Francisco, California (the Property). In the course of the
8 purchase, Brown transferred \$500,000 to Kenney. Kenney, a licensed
9 real estate broker/salesperson, agreed to manage the Property, and
10 obtained an ownership interest in the Property. The Property was
11 lost in foreclosure sometime after June 2009.

12 Brown asserted a claim against Kenney for fraud and breach of
13 fiduciary duty. Kenney asserted a counterclaim for breach of
14 contract. The dispute was referred to an arbitrator, who found
15 Kenney liable to Brown under a theory of constructive fraud and
16 awarded Brown \$500,000 in damages and \$216,255 in attorneys fees.
17 The arbitrator barred Kenney from offering evidence in support of
18 her counterclaim, because she failed to deposit her share of the
19 costs of the arbitration.

20 The arbitrator, a retired state-court judge, made numerous
21 findings of fact, including the following: that Brown and Kenney
22 were partners pursuant to an August 2005 partnership agreement;
23 that Brown transferred \$500,000 to Kenney for the purchase of the
24 Property; that Kenney was a licensed real estate broker/
25 salesperson; that Kenney agreed to manage the Property for Brown;
26 that Kenney caused money to be borrowed against the Property and
27 did not account for the loan proceeds; that Kenney collected rents
28 from the Property and did not account to Brown for those funds;

1 that Kenney occupied part of the Property without paying rent; that
2 Brown used rental income and/or loan proceeds to make improvements
3 to the portion of the Property that she occupied solely for her
4 benefit; that Kenney appropriated to her own use rental income and
5 loan proceeds from the Property; that the Property was lost in
6 foreclosure as a result of the loans Kenney caused to be made
7 against the Property; and that Brown suffered a loss of \$500,000 as
8 a result of Kenney's wrongful acts. Arbitrator's Decision at 3-8.

9 The arbitrator also made detailed conclusions of law in which
10 he explained that Kenney was liable to Brown under a species of
11 fraud by a fiduciary. The arbitrator discussed whether Kenney
12 could be held liable under a theory of defalcation by a fiduciary,
13 and concluded that although the acts in question looked very much
14 like what bankruptcy courts characterize as defalcation, California
15 law did not recognize a tort called defalcation, but would impose
16 liability on the basis that Kenney engaged in constructive fraud
17 while in a fiduciary capacity.

18 Preliminarily, it is hornbook law that partners are
19 trustees over the partnership assets, and likewise owe
20 all fiduciary duties within the meaning of 11 U.S.C. §
21 523(a)(4). (Ragsdale v. Haller (9th Cir. 1986) 780 F.2d
22 794, 795-96) Likewise, real estate agents and brokers
stand in a fiduciary relationship with their principals
and thereby owe the "same obligation of undivided service
and loyalty" owed by trustees to their beneficiaries.
(In re Niles (9th Cir. 1997) 106 F.3d 1456, 1459)

23 Claimant seeks an order imposing liability upon
24 Respondent Kenney on two theories: fraud and defalcation.
Dealing with the second theory first, Claimant contends
that the law is as follows:

25 "A fiduciary is liable for defalcation
26 where she "fails to account fully for money
received." (In re Lewis (9th Cir. 1996) 97
27 F.3d 1182, 1187) As written by Judge Learned
Hand, "(c)olloquially perhaps the word
28 'defalcation', ordinarily implies some moral
dereliction, but in the context it may have
included innocent defaults, so as to include
all fiduciaries who for any reason were short

1 in their accounts." (In re Gonzales (9th Cir.
2 BAP 1982) 22 B.R. 58, 59)" (Claimant's Proposed
Arbitrator's Award at page 7.)

3 It appears to the undersigned, however, after
4 reviewing over 100 California cases, that defalcation is
not a recognized tort cause of action in the state nor
are there any cases defining exactly what defalcation is.
5 (See *Bent v. Rivergate Commons* (2006) 2006 WL 3531425,
*4; *Ivy v. Plyler* (1966) 246 Cal.App.2d 678, 683-84.)
6 Instead, California courts have generally relied on
allegations of defalcation to support claims for, *inter*
7 *alia*, fraud.

8 Black's Law Dictionary defines defalcation, however,
as follows: the "misappropriation of trust funds or money
held in any fiduciary capacity; [the] failure to properly
9 account for such funds." (*Black's Law Dictionary* 417
(6th ed. 1990).) And in the context of bankruptcy
10 proceedings, defalcation "includes the innocent default
of a fiduciary who fails to account fully for money
11 received." (*In re Short* (9th Cir. 1987) 818 F.2d 693,
694; *In re Baird*, 114 B.R. 198, 204 (9th Cir. BAP 1990)
12 ["In the context of section 523(a)(4), the term
'defalcation' includes innocent, as well as intentional
13 or negligent defaults so as to reach the conduct of all
fiduciaries who were short in their accounts"].) As
14 such, an individual may be liable for defalcation without
having the intent to defraud. (*In re Lewis* (9th Cir.
15 1996) 97 F.3d 1182, 1186-1187.)

16 For this reason, the Arbitrator concludes that
there is not a basis for imposing liability upon
Respondent Kenney under the doctrine of defalcation.
17 The question is thus whether there is a basis for
imposing liability for fraud.

18
19 Id. at 8-10.

20 Based upon the foregoing findings of fact, the
Arbitrator finds in favor of the Claimant under the
doctrine of constructive fraud. By virtue of her role
21 as agent, broker and partner, Respondent Kenney owed
Claimant the duties of a fiduciary and was at all
22 relevant times acting in a fiduciary capacity. That
those obligations were set forth in a number of written
23 agreements between the parties, including the Tenancy in
Common Agreements, the Tenancy in Common Management
24 Agreement, the parties' partnership agreement and the
Agreement. And in her transactions with Claimant,
25 Respondent Kenney significantly failed to fulfill her
duties as a fiduciary....

26 The overall picture of this case is troublesome.
When she received \$500,000 from Claimant, she owed him
27 the duty to manage, hold and use those funds in trust for
his best interest. Her management of the funds was
28 however questionable, and she did not account for them or
allocate and use them for Claimant's benefit. Rather she
diverted them for her own benefit, using them to develop

1 the portion of the property that was to become her own
2 home at 2022 Leavenworth Street, a unit that she
3 apparently still inhabits, notwithstanding the entire
4 property having been foreclosed upon.

5 ...
6 As to what remedy should be provided to Claimant,
7 the Arbitrator concludes that the request for the return
8 of his investment is not unreasonable. Claimant was
9 damaged in that his investment in the Property of
10 \$500,000 was not returned to him. That damage was the
11 legal result of the Respondent's misrepresentations and
12 breaches of her fiduciary duties. Claimant is designated
13 the prevailing party. As such he is entitled to recover
14 costs of suit.

15 Id. at 12-13.

16 The San Francisco County Superior Court entered a judgment
17 confirming the arbitration award in March 2011. No appeal was
18 taken, and that judgment is now final.

19 Kenney filed a chapter 7 petition in this court in September
20 2011. Brown timely brought the current action seeking a
21 determination that the arbitration award be excepted from discharge
22 under section 523(a)(4). Kenney filed a counterclaim against Brown
23 for breach of contract arising from the same investment that gave
24 rise to Brown's claim against Kenney.

25 The matter is presently before the court on Brown's motion for
26 summary judgment. Brown contends that the confirmed arbitration
27 award made all the findings necessary to except Kenney's liability
28 to Brown from discharge under section 523(a)(4), and that those
findings are binding in this proceeding under principles of issue
preclusion. Brown also contends that Kenney's counterclaim should
be dismissed, because it may be asserted only by the chapter 7
trustee, and because it could have been asserted in the arbitration
proceeding and should therefore be barred under principles of claim
preclusion.

1 **DISCUSSION**

2 A. Issue Preclusion re Exception from Discharge

3 Brown seeks to have Kenney's liability under the judgment
4 affirming the arbitration award excepted from discharge under
5 section 523(a)(4). That section excepts from discharge any debt
6 "for fraud or defalcation while acting in a fiduciary capacity."
7 To prevail under section 523(a)(4), the plaintiff must show that an
8 express trust was created, that the debtor was a trustee under that
9 trust, and that trust property was lost because debtor did not
10 handle that property as required by the terms of the trust. Otto
11 v. Niles (In re Niles), 106 F.3d 1456, 1459-60 (9th Cir. 1997);
12 Lewis v. Scott (In re Lewis), 97 F.3d 1182, 1185-86 (9th Cir.
13 1996). Under California law, a partnership is an express trust,
14 under which each partner has the duties of a trustee toward other
15 partners regarding partnership property. Ragsdale v. Haller, 780
16 F.2d 794, 795-96 (9th Cir. 1986).

17 Brown contends that the arbitration decision made all the
18 findings necessary to determine that Kenney's liability under that
19 award should be excepted from Kenney's discharge under section
20 523(a)(4). This is so, Kenney contends, because the arbitration
21 decision found that Brown and Kenney were partners regarding the
22 Property, that Brown transferred \$500,000 to Kenney for partnership
23 purposes, that Kenney diverted the funds to her own use, and that
24 Brown suffered damages of \$500,000 as a result of Kenney's breach
25 of trust. Brown contends that the findings in the arbitration
26 decision are binding in the present action under principles of
27 issue preclusion.

28 This court looks to California law to determine the preclusive

1 effect of an arbitration award confirmed by a California state
2 court. Khaligh v. Hadaegh (In re Khaligh), 338 B.R. 817, 823-24
3 (B.A.P. 9th Cir. 2006). The party seeking to establish the
4 preclusive effect of a prior judgment bears the burden of proof.
5 Id. at 825. Under California law, a prior judgment bars re-
6 litigation of issues decided in the prior action to the extent that
7 the following requirements are established: the two actions
8 involved the same parties; the two actions involved the same
9 issues; the relevant issues were actually litigated; the
10 determination of those issues was necessary to the prior decision;
11 the prior decision is final and not subject to appeal; and the
12 imposition of issue preclusion is consistent with public policy.
13 Id. at 825, n3. Under California law, an arbitration award
14 confirmed by a court has the same preclusive effect as a court
15 judgment to the extent the arbitration award satisfies the elements
16 described above. Id. at 826.

17 In the present case, it is undisputed that the confirmed
18 arbitration award involved the same parties as the current action,
19 that the arbitrator heard evidence and issued a decision in which
20 he made detailed findings of fact and conclusions of law, that
21 those findings and conclusions were necessary to the award, and
22 that the judgment confirming the award is now final and not subject
23 to appeal.

24 Kenney disputes that the arbitration actually and necessarily
25 decided the same issue involved in present action: whether her
26 liability resulted from "fraud or defalcation while acting in a
27 fiduciary capacity" within the meaning of section 523(a)(4) of the
28 Bankruptcy Code. Kenney notes that the arbitrator declined to

1 award damages on a theory of defalcation, and instead imposed
2 liability on a theory of constructive fraud.

3 This argument is unpersuasive. In virtually every issue-
4 preclusion case involving a section 523 action, the statutory basis
5 for excepting the liability from discharge does not use the same
6 terms employed in the prior tort action. In Khaligh, for example,
7 the court held that a prior judgment for defamation established all
8 of the elements for excepting the resulting debt from discharge
9 under section 523(a)(6) as willful and malicious injury, even
10 though section 523(a)(6) contains no reference to defamation. Id.
11 at 831. It is necessary only that the prior decision establish
12 facts necessary to except the debt from discharge under section
13 523. Id.

14 In the present case, the arbitration decision established all
15 of the facts necessary to except the resulting debt from discharge
16 under section 523(a)(4). The required elements under section
17 523(a)(4) are: the creation of an express trust; debtor's receipt
18 of money or property as trustee of that trust; debtor's failure to
19 use or protect that property as required under the terms of the
20 trust; and damage resulting from the debtor's breach of trust.

21 Niles, 106 F.3d at 1459-60; Lewis, 97 F.3d at 1185-86. The
22 arbitrator made the following express findings of fact: that Brown
23 and Kenney were partners regarding the ownership of the Property;¹
24 that Brown transferred \$500,000 to Kenney for Kenney to use for
25 partnership purposes; that Kenney diverted the \$500,000 to her own
26 use and did not use those funds for partnership purposes; and that

27
28 ¹ As noted above, the Ninth Circuit has held that under
California law partners are trustees with respect to partnership
property for the purpose of section 523(a)(4). Ragsdale, 780 F.2d
at 795-96.

1 Brown suffered the loss of the entire \$500,000 as a result of
2 Kenney's misapplication of partnership property. Arbitrator's
3 Decision at 3-4, 12-13.

4 In determining that Kenney was liable to Brown on a theory of
5 constructive fraud, the arbitrator did not decide that there was no
6 defalcation within the meaning of section 523(a)(4) of the
7 Bankruptcy Code. The arbitrator determined only that California
8 state law did not use the term defalcation to describe the theory
9 under which Defendant was liable to Plaintiff. Arbitrator's
10 Decision at 9.

11 Kenney also contends that she was barred from introducing
12 evidence on her own behalf because she did not pay her share of the
13 costs of the arbitration. This court agrees that it has discretion
14 not to apply issue preclusion against a party that did not have a
15 full and fair opportunity to be heard in the prior proceeding.
16 Khaligh, 338 B.R. at 827-30. I determine, however, that it is not
17 unfair to give preclusive effect to the arbitrator's decision in
18 the present case. The record indicates that Kenney was barred from
19 introducing evidence only with respect to her affirmative claims
20 against Brown, and that she was not barred from introducing
21 evidence in defense of Brown's claims against her. That is what
22 the decision states happened, and that is the only sanction that
23 JAMS Rule 31(b) permits.

24 B. Defendant's Counterclaim for Breach of Contract

25 In response to Brown's complaint for a determination that the
26 confirmed arbitration award be excepted from discharge, Kenney
27 asserted a counterclaim in which she asserts that Brown is liable
28 to her in the amount of \$500,000 under various contracts between

1 the parties. Kenney acknowledges that her claim arose pre-
2 petition, and that she attempted to raise it in the arbitration
3 proceeding, but was barred from doing so because she failed to pay
4 her share of the cost of arbitration.

5 Plaintiff moves to dismiss the counterclaim on the basis that
6 it belongs to the bankruptcy estate and cannot be asserted by
7 Kenney, and on the basis that the counterclaim could have been
8 raised in the arbitration proceeding and is now barred under the
9 principles of claim preclusion.

10 I determine that the counterclaim should be dismissed without
11 prejudice for the following reasons.

12 Kenney is not the proper party to assert the counterclaim.
13 Because the claim arose pre-petition, that claim became property of
14 the bankruptcy estate pursuant to section 541(a), and must be
15 brought by the chapter 7 trustee. Kenney did not even list the
16 claim in her original schedules. Although she has now filed
17 amended schedules that value the counterclaim at \$500,000, and
18 claims \$12,500 of that value to be exempt, the counterclaim is
19 still property of the bankruptcy estate and still must be asserted
20 by the trustee. There is no indication that the trustee intends to
21 assert the counterclaim.

22 If the trustee abandons the counterclaim to Kenney, this court
23 will probably lose subject-matter jurisdiction. The counterclaim
24 arises under state law. The only basis for jurisdiction in this
25 court is that the counterclaim belongs to the estate, and that
26 resolution of the counterclaim would therefore have an effect on
27 the estate. Fietz v. Great W. Sav. and Loan Ass'n (In re Fietz),
28 852 F.2d 455 (9th Cir. 1988). Abandonment, which would permit

1 Kenney to assert the counterclaim, would also remove the
2 counterclaim from the estate and thereby eliminate the principal
3 basis for subject-matter jurisdiction. This court could
4 conceivably invoke its supplemental jurisdiction to try the
5 abandoned counterclaim, but I decline to do so because the court is
6 now ready to enter judgment on all claims raised in Brown's
7 complaint, and because to date the counterclaim has not been
8 asserted by any party with the power to do so.

9 For similar reasons, I decline to resolve Brown's contention
10 that the counterclaim is barred under principles of claim
11 preclusion. That contention should be asserted against the party
12 that holds the counterclaim. Brown rightly notes that it is only
13 the trustee who may assert the counterclaim, but he has not made
14 the trustee a party to his motion to bar that claim.

15 Finally, Brown seeks to recover the attorneys fees he incurred
16 in responding to the counterclaim, under the theory that Kenney
17 violated the automatic stay in asserting claims that belong to the
18 bankruptcy estate. See § 362(a)(3). I decline to award fees for
19 violation of the stay, because Brown was not injured by that
20 alleged violation in any manner other than having to defend a non-
21 meritorious claim.² The appropriate remedy for that type of injury
22 is supplied in Rule 9011. Brown may not recover fees under Rule
23 9011, because he did not serve a separate motion as required under
24 paragraph (c)(1)(A) of that rule.

28 ² Brown cannot show that his interest as a creditor was
impaired by Kenney's interference with the estate's prosecution of
the claim, because Brown contends that the claim has no value.

1 **CONCLUSION**

2 Judgment will be entered for Brown declaring that Kenney's
3 liability under the confirmed arbitration award is excepted from
4 discharge, and dismissing Kenney's counterclaim without prejudice
5 and without leave to amend.

6 ****END OF MEMORANDUM DECISION****
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